ACCOUNTANCY—DISCUSSION

Edward L. Suffern: Without attempting to address myself directly to the discussion of either of the two papers which have been presented to us, I shall take the liberty of offering my contribution to this meeting rather in the form of queries than as an affirmative statement.

Notwithstanding this utterance, I do make the following declaration: That, in my opinion, the manner in which the grouping of the units of costs is made should be largely determined in accordance with the specific information which the general accounting system is designed to develop.

I concede that proper economic principles must be fully recognized in every system, and that there must be due consideration of every cost, but I can conceive of conditions where the greatest business intelligence would be required in order to determine correctly how these costs should be grouped. I have in my mind the problems which already are presented to the Tariff Commissions, problems which we hope they will have fuller opportunity to study than they now enjoy. Their problem, as I understand it, will be to determine the relative costs of the units produced, in a great variety of forms, for the purpose of making comparisons as to the relative costs of these units at home and abroad.

Now my first query is, what elements of costs shall be considered for such a comparison? Is it not clear that a distinction must be made between such elements as are permanent and inherent and such as are accidental? For example—the factors absolutely inherent to each are the cost of material, the cost of labor (direct and indirect), the process cost, and the interest on costs during the period of conversion—these are permanent elements, without which no unit can be produced anywhere. In addition to these, however, there may be at least one other element which might affect the cost of production, and which should be considered from the standpoint of a comparison which is supposed to cover the whole range of any particular form of production. This is a certain form of taxes. Wherever taxation may be so levied as to become in effect a tax on output, such tax must be considered as an inherent part of the cost of production; but, if the tax be a tax on property value or a franchise tax, it need not be so considered, in my opinion, because it will then fall in another group.

This other group I call the secondary group, and it consists of the accidental items, each of which it is true is an element of cost, but each of which is affected by the conditions under which the business may be conducted rather than by the character of the business itself.

These elements are taxation and insurance, which are affected by the situs of the business; interest on capital, which would be largely affected by the ratio existing between capital requirements and capital invested; and depreciation, which is affected by the quality of the original investment, the character of usage, and developments of invention. All of these are elements which must be considered if due regard be paid to economic principles; but how shall they appear in a scheme of comparative costs? Can we separate the determinate and indeterminate factors?

My next question relates to the proper application in a general accounting system of the economic principle of exhaustion of natural resources where the same affects costs. Upon what basis shall a reserve be established? Can any definite rule be formulated, or shall the basis conform to the conditions controlling each case? If the latter, what principles shall govern? Can any element of chance be allowed to affect the application of the principles? In the case of ore beds, coal areas, and mines of other minerals, should it be insisted that provision be made to offset depletion through a retention of profits, wherever possible; or shall we assume that the economic principle of conservation may be suspended in such cases and no regard need be paid to its existence?

These questions are asked not from any purpose to inject casuistry into the discussion, but rather with the idea of trying to develop the thought that the application of the economic principles to any accounting system must be carefully and intelligently considered, and must include the conception of the peculiarities and individualities controlling each case. What is needed in any accounting system is that there shall be developed through it a record or history of facts, so displayed that they shall present an intelligible and intelligent review of transactions and conditions for the purpose of assisting practical conclusions as to future operations.

J. C. Duncan: If I interpret Mr. Dickinson correctly, he does not believe that rent and interest should be considered as costs of production, but rather views them as deductions from

profits. To the economist profit is a return over and above all rent and interest charges. If the owner of an enterprise does not secure that return it would be better for him to lend his resources to some one else who would pay him the rent and interest and assume the risks of production. Moreover, if he should lend his land and capital, he can then work for some one else and get a wage, so that even the entrepreneur's salary or wage should be considered a part of costs, because he is entitled to pay himself as much as some one else would pay him.

Mr. Dickinson in considering rent and interest as deductions from profits really gives those returns to the owner of the land and the capital, if he is not the proprietor of the enterprise. Under such a condition our point of difference is that with Mr. Dickinson's attitude the rent and interest are not included and segregated to the various divisions of the enterprise and put in as elements of costs directly.

To the speaker's mind all such charges are really direct additions to the cost of production and should be apportioned directly to the various departments involved. Rent and interest should not be regarded as divisions of profits, because profit does not start until provision is made for these items.

Professor Cole brings out one point that to the speaker's mind is very important, namely, "costs contain in themselves no element of profit for the enterprise." To the speaker's mind no profit should be added between departments, because profits can not be determined until sales are made, and should not be introduced as departmental charges. The speaker believes that if we are to establish our accounting on an economic basis all the items which in any way contribute to the make-up of the article produced should be included in the operating charges of the department. That would include material costs, labor, interest, rent, salaries, and even taxes, whether the manager is owner or not. If we take this point of view, we have an economic basis for the accounting system of any business and for all conditions of ownership of capital, land, and the use of labor.

Mr. Dickinson refers to the method railroads use in treating their rental and interest accounts. According to the rules of the Interstate Commerce Commission, these charges are considered deduction from profits, and not operating costs. If operating expense has the full significance it should have, it seems to the speaker that this omission of rental and interest charges really

leads to an incorrect statement. Rent, interest, and taxes are really operating costs, because they are contracted by the operating plant of a railroad and should be included in that division of the accounts. Unless they are so included, we have an incomplete basis for the determination of the various costs of transportation. To the writer's mind a good many of our difficulties in railroad accounting would be very largely eliminated if a serious effort were made to arrange our accounts so that the freight, passenger, mail, express, and other railroad activities would show up the sources of income and have charged to them their various expenses rather than to show up the accounts in their present way. As a matter of fact, one great cause of the present confusion of railroad accounting is due to the fact that the income side of railroad accounts is shown up on the economic basis, while the expenditure side of the income account is presented from an engineering point of view. The receipts side of the income account shows the amounts received from the freight, passenger, and the various other operating departments; it shows the rental of their lines. The expenditure side is based upon what the costs are to run the various parts of the business considered from the engineering point of view. In the latter case we have shown money expended in the maintenance of way and structure, in the maintenance of equipment, the sums used in traffic, and conducting transportation; but it is all considered from the viewpoint of the entire road, making it utterly impossible for one to have any definite idea of what each class of service takes from the treasury; while we do have shown what each class of service earns.

In addition to all this the present railroad income account distinctly keeps out of operating expenses the items of rentals, interest, taxes; and even depreciation is not regarded as a cost of operation.

Certainly the term "operating expenses" must be defined as meaning something quite different in railroad accounting from what it means in manufacturing accounting; and, moreover, with this present method of handling the expenses and receipts, we do not get a satisfactory basis for determining our costs.

Would it be better for all concerned if our railroads' income accounts were so stated that both the expenditures and receipts sides were put on the same basis? The speaker feels that a serious effort should be made to carry the proper proportions of rent,

interest, taxes, and depreciation to the various departments, like the freight, the passenger, and all others; and, furthermore, he feels that those expenses are really costs of operation and should be so regarded.

AN OUTLINE OF A RAILROAD'S INCOME AND PROFIT AND LOSS ACCOUNT

OPERATING EXPENSES	TRANSPORTATION REVENUE
Maintenance of Way and Structure	Freight
Maintenance of Equipment	Passenger
Traffic	Mail
Transportation	Express
General	Milk
OTHER THAN OPERATING	Switching
Taxes	Bridge Tolls
Rentals	Other
Interest Charges	
Discount on Securities	OTHER THAN TRANSPORTATION
Balance to Profit and Loss	Rents of Track
	Rents of Property
	Dining Cars
	Interest on Stocks and Bonds owned

PROFIT AND LOSS

Depreciation	Net Income
Dividends	
Balance to Surplus	

ALLEN R. FOOTE: I am very glad to be present on the occasion of the discussion of this question. Those of you who attended the meeting of the American Economic Association held in Washington twenty years ago this day, will remember that at that meeting Professor Henry C. Adams submitted an exceedingly able paper under the title of "Statistics as a means of Preventing Abuses by Corporations."

When Professor Adams had concluded his paper, I had the courage to say that I agreed with his paper in all respects excepting its title. I wished the title to read "Statistics as a Means of Preventing Abuses *of* Corporations."

I then suggested that the American Economic Association could do no more important or serviceable work than to formulate a scientific statement of costs in which every item of cost would be placed in a proper grouping to give to it its full economic significance, and that when such a cost statement had been devised

a system of accounting should be recommended that would bring it into practical use.

The discussion this evening is the first response of which I have knowledge that has been made to that suggestion. Therefore, I am exceedingly pleased that this discussion has been arranged, and am greatly encouraged by the propositions that have been here advocated.

I hope to see the time come when the corporation laws of every state will contain a provision requiring every corporation to have a fixed date for its fiscal year, and when the stockholders of the corporation will annually select a certified public accountant to make an audit of its business affairs and prepare and submit to the stockholders a scientifically formulated statement of its true economic condition.

When this is done, such statements will contain all the information that can be reasonably required by the federal and by the state governments on which to base their policy for the regulation and taxation of corporations. This will obviate the necessity of the employment of an army of government inspectors.

L. G. Powers: I wish at the outset to bear testimony to the great pleasure I have taken in the presentation of the subject to which we have listened. It calls attention to the need of more definiteness and a greater application of scientific principles to the work of accountancy. Accountants desire to have recognition as professional men, and a recognition of their work as a branch or subdivision of science. It is a requisite of science to have an exact and definite terminology, and scientists are constantly endeavoring to use terms with definite meaning and never to use one term with two different meanings; and accountancy, which has made great and notable progress in the last fifty years, cannot be designated as a science until it develops a scientific terminology.

One particular in which accountancy is very deficient in this respect is the accountant's use of the word "reserve." This word is used with at least three and sometimes more distinct meanings. Thus, it is given the meaning of an asset set aside for a definite purpose, as, the assets of a reserve fund such as those of a government sinking-fund, which can only be used for the purpose of amortizing specific debts. A second use of the term is that which gives it the meaning of a portion of the undivided surplus of a

commercial enterprise, which has been set aside for a definite purpose. A third use of the word "reserve" is met with in the case of enterprises that do not write off depreciation from their asset accounts, but carry a credit depreciation account to which they give the designation "reserve." Such reserve does not represent an "asset" nor a portion of "undivided surplus", but merely an offset to asset values. It is a negation of values. Errors and misconceptions arise when accounts are so kept that the word "reserve" is used with one of these meanings and its actual significance is not disclosed. Greater error and misconception arise when accountants construct a balance sheet on which a single credit item includes all three of these classes of reserves.

As a result of a failure of the average accountant to differentiate these three classes of reserves, the average balance sheet conveys but little exact information to one who is uninitiated in the secrets of a business, and ofttimes such sheets are very misleading. Thus, for illustration, the triple use of the word "reserve", without any effort to differentiate between the three distinct facts of accountancy to which reference has been made, is resorted to at the present time by many public service corporations to assist them in collecting exorbitant charges for their services, in order that they may provide what they call a proper reserve for depreciation, bad debts, etc., but which in reality is for the purpose of creating an enormous undivided surplus unjustly, at the expense of the public.

Another wrong business practice that is fostered and preserved by this triple use of the word "reserve" is that employed by corporation officers, who, under cover of this term, conceal the fact that the assets are being improperly used up in current operations, and no proper provision is made for depreciation.

These are a few of the many vicious business results and business practices that are today fostered by the accountants' failure to apply scientific usages to their business, and to differentiate the various classes of data which they include under the common word "reserve."

Accountants may say, as some of them have said to me, that business men do not want to separate these classes of data by any distinct terminology, and that they must yield to the business men's wishes in the matter. I should like to ask, is this the proper attitude of the profession, if it is seeking to come before the public in the capacity of an impartial witness with reference

to the business standing of the enterprises whose affairs it is called upon to audit in the joint interest of the public, the stockholders, and the business management?

A. Lowes Dickinson: I have listened to Professor Cole's paper with great interest. It seems that the main point of difference between his views and my own lie in the treatment of rent and interest, which Professor Cole considers should, in part, at any rate, be treated as cost. An interest rate entirely exclusive of the element of risk is a myth and no such rate in practice exists. Even the rate of two per cent on United States government bonds, can not be said to be wholly without risk, for the reason that it is quite conceivable that such bonds might in time of national adversity fall very considerably in value. The more I consider the subject the more I incline to the conclusion that in practice at any rate—it would seem to him also in theory—interest and rent (so far as the latter represents a payment for the use of land and buildings and not any charge for other services) could only be considered as a division of profit, and that the adoption of any other principle must lead to injustice and error. This may be emphasized by referring to the Tariff Commission, whose duty it is to inquire into the cost of manufacture of various articles in this country as compared with similar articles abroad. To give effect in such cost to any item of interest is, in fact, to take into consideration as part of the cost the higher profit which the manufacturers in this country realize as compared with those abroad. While the propriety of an import duty to offset the increased cost of production in this country might be justifiable, it would be very hard indeed to justify an import duty for the purpose of enabling manufacturers and others to continue to earn the much higher rates of interest and profit which prevail here.

Referring to Professor Duncan's interesting address and charts, I would say that the problem of segregating railroad operating expenses between freight and passenger traffic is not a new one, but it has hitherto been found impossible of solution. I agree with Professor Gilman in thinking that a much larger proportion of the expense now treated as applicable to both classes of traffic might be segregated, but the case which Professor Gilman cites has shown a very great diversity of opinion between experts on this subject. I believe I am right in saying that three sets of experts dealt with this question in that case—one set produced figures

to show that the passenger traffic of the railroad in question yielded a profit of something like $1,000,000 a year; the second set showed equally conclusively that the expenses were about equal to the receipts; whereas, the third set showed that this class of traffic resulted in a loss of approximately $1,000,000. Such figures show that any methods at present in use must be wholly unreliable. While many items of expense might be divided which are not so divided at present, I would call attention to the item of maintenance of way and structures, involving approximately one quarter of the total operating expenses. It would require very considerable ingenuity to divide this expense between freight and passenger traffic on any but a most arbitrary basis.

On behalf of my profession and myself I wish to express thanks to Professor Cole for his very interesting paper and particularly for the high standards of accounting which he upholds therein.